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Message Text

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R 021540Z AUG 78
FM AMEMBASSY BONN
TO SECSTATE WASHDC 0785
INFO AMEMBASSY OTTAWA
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EC COLLECTIVE
USMISSION USBERLIN
AMCONSUL BREMEN
AMCONSUL DUSSELDORF
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AMCONSUL STUTTGART

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PARIS ALSO FOR USOECD

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E.O. 11652: GDS
TAGS: PINT, EFIN, GW
SUBJECT: THE POLITICS OF TAX REFORM IN THE FRG

REF: (A) 77 BONN 10163, (B) BONN 12355
(C) BONN 13867, (D) BONN 13947

BEGIN SUMMARY: IN THE MONTHS AHEAD, FRG POLITICAL DEBATE WILL FOCUS HEAVILY ON THE ECONOMIC STIMULATIVE PACKAGE WHICH CHANCELLOR SCHMIDT PRESENTED ON JULY 28
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(REFS C AND D). FEW ISSUES WILL COMMAND MORE ATTENTION, OR GENERATE MORE HEAT, WHEN THE BUNDESTAG RECONVENES ON SEPTEMBER L8. IT IS CERTAIN THAT THE OPPOSITION CDU/CSU, AND SOME SPD CIRCLES,WILL SEEK CHANGES IN THE JULY 28 PACKAGE. IT SEEMS LIKELY THAT THE FEDERAL REPUBLIC WILL EVENTUALLY HAVE A LAW INCORPORATING DEMANDS BY THE GOVERNMENT AND THE OPPOSITION, FOR WHICH

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BOTH SIDES WILL TAKE CREDIT WITH AN EYE TO THE NEXT ELECTIONS. IN THIS MESSAGE, WE LAY OUT THE POLITICAL FACTORS WHICH WILL CONDITION DEBATE ON THE JULY 28 PACKAGE AND INFLUENCE THE FINAL RESULT. END SUMMARY.

BACKGROUND

1. IN PUTTING TOGETHER THE JULY 28 PROPOSALS, CHANCELLOR SCHMIDT HAD THREE MAJOR GOALS:

--TO MEET HIS COMMITMENTS AT THE BONN ECONOMIC SUMMIT LAST MONTH;

--TO BOLSTER THE POSITION OF THE FREE DEMOCRATIC PARTY (FDP) IN THE INTEREST OF HIS GOVERNMENT COALITION; AND

--TO KEEP THE SOCIAL DEMOCRATIC PARTY (SPD) IN LINE - I.E., TO PREVENT LEFT-WING SPD DEPUTIES FROM VOTING AGAINST THIS PACKAGE.

THE JULY 28 FORMULA APPEARS ADEQUATE TO THESE PURPOSES. IT OFFERS A SKILLFUL BLEND OF BENEFITS, WITH SOMETHING FOR EVERYONE: E.G., REFORM OF THE INCOME TAX, NEW BENEFITS FOR FAMILIES, BUSINESS TAX REDUCTIONS, OUTLAYS FOR R & D AND ENVIRONMENT.
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2. FOR SOME TIME, TAX REFORM AND ECONOMIC STIMULUS HAVE BEEN POLITICAL ISSUES IN THE FEDERAL REPUBLIC. SINCE 1975, THERE HAS BEEN A LEGISLATIVE COMMITMENT TO REFORM THE PROGRESSION RATE OF THE FRG INCOME TAX. AS INFLATION AND PROSPERITY HAVE MOVED MORE CITIZENS INTO THE HIGHER BRACKET, POPULAR DEMAND FOR RELIEF HAS GROWN. THE NASCENT TAXPAYERS PARTY OF HERMANN FREDERSDORF, HIMSELF AN SPD MEMBER, REVEALS THE POPULAR MOOD. FREDERSDORF HAS GIVEN PAUSE TO ALL PARTIES, ESPECIALLY TO THE FDP WHICH IS REELING FROM ITS LOSSES IN THE JUNE 4 STATE ELECTIONS. FINALLY, THE SCHMIDT GOVERNMENT FACES CONSTANT PRESSURE FROM THE CDU/CSU, WHICH HISTORICALLY HAS PUSHED HARDER FOR TAX REFORM AND, AS AN OPPOSITION, CAN ALWAYS DEMAND MORE THAN THE GOVERNMENT CAN PRODUCE.

STRATEGY OF THE SPD/FDP GOVERNMENT

3. THE LEADERS OF THE SOCIAL-LIBERAL COALITION, CHANCELLOR SCHMIDT AND FDP CHAIRMAN GENSCHER, HAVE SO FAR SCRUPULOUSLY PRAISED THE JULY 28 PACKAGE AS A JOINT EFFORT BY THEIR PARTIES, AND AS PROOF THAT THEIR

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COALITION IS SOUND AND CAPABLE OF MAKING TOUGH
DECISIONS. THEY ARGUE (CORRECTLY) THAT THE FRG HAS NOW
MET ITS PLEDGE AT THE BONN ECONOMIC SUMMIT, AND THEY

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DEFEND THEIR PROPOSALS IN PART AS SERVING THE CAUSE OF A
REVIVED WORLD ECONOMY. AT THE SAME TIME, SCHMIDT KNOWS
THAT, IN ORDER TO PASS THIS BILL, HE MUST COMPROMISE
WITH THE LEFT-WING OF HIS PARTY, AND WITH THE OPPOSITION
CDU/CSU. THROUGH HIS FINANCE MINISTER, SCHMIDT HAS
CAUTIOUSLY INDICATED A WILLINGNESS TO CONSIDER "REASON-
ABLE" AMENDMENTS.

4. TO SOME EXTENT, THIS PACKAGE IS AN SPD EFFORT TO
SHORE UP THE BONN COALITION BY ACCOMMODATING THE
EMBATTLED FDP. INDEED, MUCH OF THE DRIVE FOR THIS
PACKAGE CAME FROM THE FREE DEMOCRATS WHO, AFTER THEIR

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JUNE 4 DEBACLE, MOVED TO SHARPEN THEIR PUBLIC IMAGE BY CALLING FOR MAJOR TAX REFORMS EFFECTIVE NEXT JANUARY 1. WITH SOME JUSTIFICATION, THE FDP CAN NOW CLAIM - AND IS CLAIMING - THAT THE JULY 28 PROPOSAL EMBODIES MUCH OF WHAT IT HAD PROPOSED. THE PARTY HOPES THEREBY TO GAIN POLITICAL DIVIDENDS IN THE CRITICAL OCTOBER ELECTIONS IN HESSE AND BAVARIA.

5. WITHIN THE COALITION, SCHMIDT'S PROBLEM IS TO BALANCE POPULAR CREDIT FOR THE FDP (WITH FEWER KUDOS FOR THE SPD) AGAINST A PREDICTABLE OPPOSITION FROM THE SPD LEFT WHICH VISCERALLY OPPOSES ANY BENEFITS TO THE WELL-TO-DO. MANY SPD CIRCLES VIEW PAST TAX REFORMS AS COALITION COMPROMISES WHICH GAVE FAVORS TO THE RICH AND DID LITTLE TO CREATE JOBS. IN PRINCIPLE, THESE GROUPS RESENT A COALITION DYNAMIC WHICH REQUIRES THE SPD TO YIELD TO ITS JUNIOR PARTNER ON BASIC ISSUES SUCH AS TAXES. ALREADY, ONE SPD DEPUTY, A "TAX REBEL" FROM THE JUNE 1977 VOTE (REF A), HAS ANNOUNCED THAT HE WILL TRY TO AMEND THE JULY 28 PACKAGE TO MAKE IT FAIRER TO THOSE ON LOW INCOMES.

6. THE CHANCELLOR THUS HAS TO LOBBY HIS PARTY HEAVILY, IN ORDER TO SECURE BUNDESTAG APPROVAL OF HIS BILL. IN THIS EFFORT, HE HAS SEVERAL ADVANTAGES. THE PACKAGE HAS SOME "SOCIAL" COMPONENTS - E.G., BENEFITS FOR MOTHERS, ENHANCED CHILDREN'S DEDUCTIONS, EARLIER RETIREMENT FOR THE HANDICAPPED - WHICH WILL MAKE IT DIFFICULT FOR POTENTIAL SPD DISSIDENTS TO VOTE "NO." FOR THE MOMENT, SCHMIDT CAN DRAW ON ENORMOUS PERSONAL PRESTIGE, CONFIRMED BY RECENT POLLS, AS A RESULT OF HIS HANDLING OF THE ECONOMIC SUMMIT AND OTHER RECENT MEETINGS IN BONN. HOWEVER, SCHMIDT COMMANDS ONLY A THIN MAJORITY IN THE CONFIDENTIAL

BUNDESTAG (10), AND HE IS MINDFUL OF THE ABILITY OF A HANDFUL OF COALITION DEPUTIES (FIVE) TO DENY HIM THAT MAJORITY.

STRATEGY OF THE CDU/CSU OPPOSITION

7. THE UNION WANTS BOTH A TAX BILL AND POLITICAL CAPITAL AT THE EXPENSE OF THE SCHMIDT GOVERNMENT. ITS POSITION ON THE JULY 28 PROPOSAL IS STILL EVOLVING, AND

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IT IS CLEAR THAT THE CDU/CSU LEADERS HAVE NOT YET FOUND AN AGREED STRATEGY. SOME, LIKE STRAUSS, HAVE CALLED THE JULY 28 PROPOSAL INFLATIONARY; OTHERS, LIKE STOLTENBERG, HAVE CALLED IT INADEQUATE.

8. AT A MINIMUM, THE CDU/CSU WILL SEEK TO POSTPONE THE VAT INCREASE, TO RAISE THE BUSINESS TAX REDUCTION, AND TO FORCE THE GOVERNMENT TO CUT NEW EXPENDITURES IN ORDER TO CURB INFLATION. IT WILL CHASTISE SCHMIDT FOR FAILING TO SEEK A MAJOR REFORM OF THE INCOME TAX SYSTEM. FINALLY, THE OPPOSITION WILL WORK TO CREATE PUBLIC UNCERTAINTY ABOUT WHAT THE SCHMIDT PACKAGE WILL DO, SO AS TO DELAY ITS IMPACT AND - HOPEFULLY - REAP SOME POLITICAL GAIN.

9. THE CDU/CSU'S STRONGEST CARD LIES IN THE BUNDESRAT, THE UPPER HOUSE WHICH MUST APPROVE ANY TAX BILL. THERE, IN CONTRAST TO THE BUNDESTAG, THE OPPOSITION HAS AN ABSOLUTE MAJORITY. ULTIMATELY, SCHMIDT MUST BRING THROUGH THE BUNDESTAG A BILL WHICH THE UNION WILL APPROVE IN THE BUNDESRAT. THIS WILL REQUIRE SKILLFUL HORSETRADING AND FLOOR MANAGEMENT, BECAUSE THE CDU/CSU HAS ALREADY ANNOUNCED PLANS TO MAKE "SIGNIFICANT CHANGES" IN THE UPPER HOUSE.

10. THE UNION FACES A STRONG, PERHAPS IRRESISTIBLE, TEMPTATION TO AMEND THE BILL IN A WAY WHICH MAKES IT CONFIDENTIAL

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MORE DIFFICULT FOR THE SPD LEFT-WING TO GO ALONG. (DRIVING A WEDGE BETWEEN SCHMIDT AND HIS LEFT-WING, AND BETWEEN THE SPD AND THE FDP, HAS LONG BEEN A CDU/CSU GOAL.) FOR EXAMPLE, THE "BUNDESRAT ADDITION" COULD

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INCLUDE MORE FAVORABLE PROPOSALS ON BUSINESS DEPRECIATION OR THE PROPERTY TAX. THESE ARE THE KINDS OF ISSUES ON WHICH THE SPD LEFT NORMALLY SEES RED, AND OVER WHICH SEVERAL SPD DEPUTIES BOLTED RANKS IN THE BUNDESTAG DEBATE ON ANOTHER TAX BILL LAST JUNE (REF A).

11. ON THE OTHER HAND, THE OPPOSITION HAS BEEN SLIGHTLY OUTMANEUVERED BY THIS PACKAGE. IN JUNE, THE SPD/FDP COALITION VOTED DOWN A CDU/CSU PROPOSAL FOR TAX REFORM, ON THE GROUNDS THAT IT WOULD BE BEST TO AWAIT THE OUT-COME OF THE ECONOMIC SUMMIT. NOW THAT THE SUMMIT IS OVER, SCHMIDT HAS PRESENTED A PACKAGE WHICH, IN SOME CONFIDENTIAL

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RESPECTS, RESEMBLES THE CDU/CSU PROPOSALS. THE OPPOSI-TION HAS NOTED THIS POINT, BUT PUBLIC CREDIT SO FAR GOES TO THE COALITION.

VARIABLES IN THE EQUATION

12. AT LEAST THREE OTHER VARIABLES ARE INVOLVED IN THE COMPLEX NEGOTIATION THAT LIES AHEAD. WE CANNOT YET ASSESS THEIR IMPACT, BUT THEIR POTENTIAL RELEVANCE IS GREAT.

A. THE CAMPAIGN FOR THE HESSE ELECTION WILL FORCE ALL PARTIES TO TAKE A STAND ON THE JULY 28 PROPOSALS. THE OCTOBER 8 VOTE COULD DRAMATICALLY AFFECT THE OUT-

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COME - I.E., AN FDP FAILURE TO SURMOUNT THE FIVE-PERCENT BARRIER, OR A CDU VICTORY WOULD CHANGE THE ENTIRE DEBATE.

B. SCHMIDT MUST FIND A MEANS TO COMPENSATE LOCAL GOVERNMENTS FOR THE MASSIVE SHORTFALLS IN REVENUE WHICH THE JULY 28 PROPOSALS WILL CREATE. CURIOUSLY, THIS PROBLEM AFFLICTS SPD-GOVERNED AREAS, PARTICULARLY IN NORTHRHINE-WESTPHALIA, MORE THAN CDU/CSU-GOVERNED ONES. THE ORGANIZATION OF GERMAN CITIES HAS ALREADY EXPRESSED STRONG CONCERN OVER ELEMENTS OF THE JULY 28 PACKAGE.

C. THE FEDERAL GOVERNMENT AND THE LAENDER WILL SOON RENEGOTIATE THEIR DIVISION OF REVENUES FROM THE VALUE-ADDED TAX. DEBATE ON THE JULY 28 PACKAGE WILL INFLUENCE, AND BE AFFECTED BY, THAT NEGOTIATION.

OUTLOOK

13. THE PACKAGE WHICH SCHMIDT PRESENTED LAST FRIDAY
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IS ONLY THE FIRST DRAFT OF A BILL WHOSE FUTURE IS UNCERTAIN. SCHMIDT KNOWS THAT HE MUST ACCEPT SOME CDU/CSU DEMANDS AS THE PRICE FOR PASSAGE. HE WILL TRY TO DO SO IN A WAY WHICH PREVENTS THE UNION FROM GETTING TOO MUCH CREDIT FOR THE FINAL RESULT. DEBATE ON THIS BILL WILL ALSO PRODUCE TENSION IN SPD RANKS, AND THE DANGER OF DEFECTIONS IN THE BUNDESTAG VOTE. BY CONTRAST, IT IS ALMOST CERTAIN THAT THE FDP, WITH ITS BACK AGAINST THE WALL, WILL NOT ALLOW ITSELF THE LUXURY OF MAVERICK VOTING.

14. ULTIMATELY, ALL PARTIES WANT TO PRODUCE A BILL WHICH THEY CAN SELL AS TAX REFORM AND ECONOMIC STIMULUS, AND FOR WHICH THEY CAN CLAIM CREDIT AT THE POLLS. THE FINAL PRODUCT, IF THERE IS TO BE ONE, MUST NECESSARILY REFLECT EFFORTS BY BOTH THE GOVERNMENT AND THE OPPOSITION.
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